1963

Preserving value of an interest in a closely held business

Thomas W. Hudson

Preserving Value of an Interest in a Closely Held Business

by Thomas W. Hudson, Jr.
Partner, Atlanta Office

Presented before the Florida Estate Planning Council, Miami—February 1963

Since the end of World War II, many business enterprises have experienced phenomenal growth. It has not been unusual to see such growth manifested in a business enterprise owned by one man, or a man and his family. Often a business started with a small original investment has grown until, today, it has substantial value—maybe $100,000, $500,000 or $1,000,000, or perhaps much more. Other substantial business enterprises may have been owned and managed by the same family for several generations.

Regardless of the origin or age of the enterprise, where the value of an interest in a closely held business enterprise constitutes the major asset of the owner, some difficult—sometimes frustrating—estate planning problems arise. The scope of these problems is reflected by some basic questions:

- How and what does the owner wish to provide for his family?
- What will be the source of cash for payment of estate taxes and administration expense?
- Who will run the business after the owner's death?

The value of the interest in the enterprise may continue to increase. While this increase in value may be a tribute to good management aided by favorable economic conditions, it also tends to magnify the problem of meeting cash requirements of the owner's estate. Yet the failure to make adequate plans to meet these requirements could force the executors to dispose of the business interest of the deceased owner, possibly under unfavorable conditions, thereby defeating the wishes of the testator.

The owner of a closely held business is occupied constantly with the daily problems of business management. Frequently, his active management and guidance is the key to the continued growth and success of the business. Nevertheless, if an individual expects to continue owning and managing a business until the time of his death, and if that business is the principal asset of his estate, he must realistically seek an answer to the question of what will happen to his business and who will run it after his death. Failure to plan for the orderly succession of capable management can lead to the dissipation of an asset that took a lifetime or longer to build. If the major asset of the estate is thus dissipated, then much of the other planning will have been an exercise in futility. At the risk of being overly dramatic, this might be compared to spending years planning the Normandy invasion only to discover at H-hour, when the troops were ready to execute the plans, that they had no equipment.

Consider, then, some personal and business matters to be taken into account and some techniques available in planning to preserve the value of an interest in a closely held business.

PERSONAL CONSIDERATIONS

The owner of a closely held business interest must dispose of it eventually—if not during life, then upon his death. As is true of other areas of estate planning, the time and method of disposition of the business interest must be integrated into the total plan for the individual.

Some of the main factors influencing the total plan will directly influence any plans with respect to the business interest. Conversely, in many cases, the over-all plan may be shaped around plans for disposing of the business interest.

Does the owner, or any member of his family, have any significant source of income other than from the owner's business? Will this source of income continue beyond the death of the owner? What income will the wife reasonably require if she survives the owner? How many children are there? What are their ages? What income is needed for their education and support?

If the owner has children, are any of them genuinely interested in the business? This question may present the owner with one of his toughest, but most critical, decisions. If an owner has one or more sons who have all reached their majority and who have not demonstrated even the slightest interest in Dad's business, would it not be appropriate to ask this man at an opportune moment, "Who will take over your business when you are no longer able to run it?"

What is the owner's age? Is he in good health? Does he wish to continue working until incapacitated? Or would he prefer to plan on retiring at some particular time in the future?

No doubt other purely personal questions, apart from those pertaining to the business, should be considered. In most cases the answers to the personal questions already enumerated will exert a dominant influence on the estate plan.

An analysis of personal objectives, obviously, is not enough. Personal objectives must, in turn, be tempered by a realistic consideration of questions pertaining to the business.

BUSINESS CONSIDERATIONS

Over the long run, general and local economic conditions, trends within a given industry, and effectiveness of management may be the most potent forces influencing the value of a closely held business interest. However, to the extent possible, an attempt should be made to anticipate and avoid circumstances that may adversely affect the value of a business interest. Generally our client—the owner of the business interest—is the one who should conscientiously appraise the risks and future prospects of his business.

Since most people still believe "You can't take it with you," then sooner or later the owner of a business interest must reach one of three conclusions:

- To keep the business in the family by transferring it by gift or bequest to one or more members of the owner's family
- To sell the business to parties outside the family and invest the proceeds in other forms of income-producing property
- To combine the business, by merger, consolidation, or otherwise, with some other business enterprise

The first possibility may be the result of a carefully reasoned decision—or it could arise by default. The second and third possibilities require some affirmative action on the part of the owner. If left to time and to fate, the conclusion could be the wrong one. Some questions that may influence the owner's decision are discussed in succeeding paragraphs.

Presence of Business Partner

Does our client have a business partner—whether as an actual partner or as a stockholder in a corporation? If so, can this partner be relied upon to carry on after our client's death? Two men may work together for a lifetime, but when death takes one, will the survivor be content to see profits inure to the benefit of his partner's family, who are now passive investors?

Succession of Management

If there is no business partner, does the business have capable management to carry on in the event of the owner's death? Will it be possible to retain capable management, with or without making available a proprietary interest in the business?

Is the successor management likely to maintain harmonious relations with surviving family members who succeed to the ownership of the business? It is a sad and familiar story, but cases still arise where incessant demands for dividends by the surviving widow or children conflict with the judgment of the successor management. This kind of conflict can imperil the sound management of a business with severe adverse consequences on future earnings and dividend-paying capacity.

Financial Strength of Business

How strong is the financial condition of the business? Will the financial condition permit the payment of sufficient dividends to meet the income needs of survivors? Assuming the business interest is incorporated, does the liquidity of the owner's estate depend in part on the redemption of stock? If the value of the business interest meets certain tests in relation to the gross or net estate, such a redemption, to the extent of the estate taxes, funeral expenses, and administrative expenses, will be treated as a sale of the stock and will not be treated as a dividend. However, the income tax treatment may be entirely academic if the financial condition of the business would be impaired by a redemption of the deceased owner's stock.

Dependence on One Person

Just how much does the success of the business depend on the personality, drive, and ability of our client? Once death removes him from the scene, what will be the value of the business as a going enterprise? Is it possible that the value of the enterprise will be limited to its value in liquidation? If so, the business enterprise will have lost its value as a prime resource for the family of the deceased owner. This circumstance will, no doubt, reduce the estate tax bill substantially, but this is not the recommended approach to tax savings.

AVAILABLE ESTATE PLANNING AIDS

Though many of the questions raised cannot be answered in a clear-cut manner, the owner of a business interest should be cautioned against making irrevocable commitments based on hastily conceived arrangements. He should be encouraged to discuss the problems surrounding his business interest and his personal desires with each member of the estate-planning team. Careful exploration of problems and full discussion will be mutually advantageous—especially to our client whose best interest should be uppermost in the minds of all concerned.

As our client's decisions begin to crystallize—sometimes this takes years, or may never happen—consider a number of techniques presently available which, when used properly, will help him accomplish his objectives.

Sale of Business

Assume our client has decided to sell his business interest and retire. His familiarity with the trade, knowledge of prospective buyers, and ability to value the going business probably will enable him to obtain a much better price than could an executor who does not have the same intimate familiarity with the business. If the personality and ability of our client is the principal factor in valuing the business, realization of this value may lie in the fact he could be retained under a management contract or other arrangement to provide an orderly transition to individuals representing the new owner.

Sometimes the value of a closely held business has grown to the point where prospective buyers are discouraged by the amount of the purchase price. In this type of situation it may be possible to accomplish the same result by selling part of the interest and redeeming the remaining interest. As an example, assume an incorporated business, having but one stockholder, is worth $500,000, and its books show the following capital and surplus:

Common stock—1,000 shares cf $100 par value each	$100,000
Earned surplus	300,000
Total	$400,000

An interested buyer has no quarrel about value but can pay or finance not more than $300,000. To make the deal, the present owner can sell 600 shares for $300,000; subsequently he redeems 400 shares for $200,000 leaving the company's capital and surplus as follows:

Common stock—600 shares of $100 par value each	$ 60,000
Earned surplus	140,000
Total	$200,000

Assume further that the owner's basis of the 1,000 shares was \$100,000; therefore, he would realize a profit of \$400,000 on the sale and redemption and at present capital gain rates would pay \$100,000 in taxes. Suppose (for simplicity of illustration) terms of the sale and redemption had the effect of spreading the price equally over a period of ten years. If it is assumed also that the seller elects to report the profit on the instalment basis, is married, and has other income equal to his exemptions and itemized deductions, then the tax at 1963 rates would be \$5,280 each year or a total of \$52,800; this is \$47,200 less than if the profit were all reported in one year.

Now carry the illustration a step further. Assume the instalment arrangement for sale of the 600 shares is satisfactory, but the owner would like to complete the redemption of the 400 shares without placing an undue burden on the cash resources of the company. Arrangements are made for the company to distribute \$40,000 in cash (this amount, just incidentally, will a little more than cover the income taxes due) and real estate which cost the company \$100,000 and now is valued at \$160,000. The company also benefits here because it is not taxed on the difference between the cost and appreciated value of property distributed in redemption of its stock. If the company should need the property in its business, it might arrange a suitable lease. The rental income also would provide a source of additional income for our client and his family.

Other variations of the instalment sale may be very useful. Consider an individual, age 65, who owns fifty per cent of the stock of a company, the remaining fifty per cent being owned by younger members of his family who are active in the business. He may choose to redeem his stock with less than thirty per cent of the redemption price being payable immediately and the balance payable in equal instalments over a period of twenty years. This technique may accomplish several desirable objectives. The redemption price may be negotiated and fixed during the life of the owner. The long terms of payment may provide substantial income tax savings and at the same time avoid burdensome demands on the company. In the event of the death of the owner before the full redemption price has been paid, the indebtedness of the company will likely eliminate substantial valuation problems while providing a source of cash for the estate. Any such plan should, of course, take into account the owner's intended use of funds collected and the relative potential effect of both income and estate taxes.

Recapitalization

The device known as a recapitalization has a variety of valuable uses. A recapitalization generally contemplates the rearrangement of a corporation's capital structure effected in such a way that no taxable gain or loss will be recognized by the shareholders or the corporation. Through this device, the owner of substantial voting stock in a corporation may change his equity interest to other classes of stock.

In some circumstances, the later redemption or other disposition of preferred or other nonvoting stock issued in a recapitalization could be subject to unfavorable income tax treatment. If the owner, or a person who received the stock as a gift from the owner, should later redeem the preferred stock, the amount received may be treated as a dividend and taxed as ordinary income. If the preferred stock is transmitted by bequest, the later redemption by the estate of the owner or a beneficiary of his estate would not be subject to dividend treatment. Because the hazards of dividend treatment can be extremely severe, the use of the recapitalization should be based on thorough study and planning tempered by a reasonable analysis of the risks.

The presence of some risks should not necessarily limit use of the recapitalization; it merely emphasizes the need for fairly weighing the risks and taking steps to avoid or minimize the exposure.

Refer to the previous illustration where an interested buyer can pay or finance only $300,000 toward purchase of a business worth $500,000. In a recapitalization, the company might issue 2,000 shares of preferred stock (worth $200,000) in exchange for 400 shares of common, after which the capital and surplus would appear on the company books as follows:

Common stock—600 shares at $100 par value each	$ 60,000
Preferred stock—2,000 shares at $100 par value each	200,000
Earned surplus	140,000
Total	$400,000

After issuance of the preferred stock, the buyer presumably could purchase the entire voting stock of the company for $300,000.

There is always a strong possibility a client will want to retain his business interest within his family. If this be true, a recapitalization may again be a useful device to protect the value that has been built up in the business. Through a recapitalization it may be possible to rearrange the equity interests to minimize conflicts between members of a family. Such conflicts could seriously impair the value of an interest in a business enterprise.

Through recapitalization, the owner may exchange a portion of his common stock for preferred stock in the business enterprise. A variation similar to a recapitalization would be for the company to pay a stock dividend in preferred capital stock. (In either event, the owner's total equity remains the same—it simply has been divided into preferred and common stock.) The owner is now in a position to transfer, if he chooses, by bequest or gift, preferred stock to his wife or children who are not expected to participate in the management of the business. The common stock may, in turn, be transferred by gift or by bequest to the family members who will be responsible for the active management of the business.

In another situation, an owner who has previously given some of his common stock to one or more sons who actively participate in the business, may decide to retire and leave the active management of the concern to his sons. Again, through the device of recapitalization, he may exchange a sufficient portion of common stock held by him for preferred stock so that after the exchange his sons have voting control of the business enterprise.

Where the stock of a business enterprise was held by members of two or three family groups, the recapitalization device also has been used to shift control of the business from older stockholders to a younger group of stockholders.

In another variation, the recapitalization has been used to shift the control of a closely held business where two unrelated stockholders have each owned fifty per cent of the stock of a company. Occasionally it has developed over a period of years that one stockholder has sons who have taken an active interest in the business, while the other stockholder either has no children or has none who are interested in the business. In such situations, the recapitalization device has been used as a means of shifting the voting control to one family while permitting the other family, which does not participate in the conduct of the business, to hold a nonvoting equity interest as a source of income.

Separation of Business

If a business concern engages in two or more general areas of activity, dividing the business into separate corporations may, for a number of reasons, best serve the objective of preserving value. If certain technical requirements are met, the two businesses may be separated without the recognition of taxable gain or loss to the stockholders or to the corporations. This technique, known as a spin-off or a split-up, provides a means of satisfying dissident shareholders or of separating areas of responsibility among members of a family. Some support also exists for using this approach for dividing a single business into two separate corporations, although the Internal Revenue Service still takes the position such a transaction results in a taxable distribution to stockholders.

Merger or Consolidation

The possibility always exists that the owner would like to retain the business interest in his family, but that adequate provisions likely cannot be made for orderly succession of management within the framework of existing organization and ownership. These conditions often lead to combination through merger or consolidation with another enterprise that is able to provide successor management. The merger or consolidation route sometimes provides one of the best avenues for preserving value of a business interest, especially when the absence of successor management may allow the business to wither away after the owner's death or incapacitation. A further benefit occurs when the owner converts his interest in a closely held business into an interest in a company whose securities are traded sufficiently to have an established market value.

Stock-Purchase Agreement

As previously indicated, an arrangement for the redemption of stock through a purchase agreement to be exercised upon the death of one of several principal owners can be a valuable vehicle for preserving value, and for making cash available to the owner's estate. However, a poorly planned stock-purchase agreement may have serious adverse effects tending to diminish rather than preserve value. Probably one of the areas of greatest difficulty is in setting a fair formula for determining the price to be paid. Some suggested guides for determining the price would include:

- Generally avoid setting a fixed price. Because of changing economic conditions, a fixed price may prove unfair to the owner's family or the company.
- If net income is a factor in a formula for determining price:

a) Specify that net income is to be determined according to generally accepted accounting principles.

b) Average the income for a period of years. The period should take into account cyclical swings in the business.

c) Specify clearly how to determine the years to be taken into account. Indicate how to treat periods of less than a year between the close of a fiscal year and the date of death.

- Consider averaging the prices determined under two or more price formulas.
- If certain assets are to be valued at fair market value, specify how market value shall be determined.
- Consider providing a means of setting a maximum or minimum purchase price—i.e., as a percentage of book value.
- Make provision for arbitration or other means for final settlement of any disputes that might arise with reference to valuation or to the determination of the purchase price.
- Be sure to test thoroughly the computations of price under a variety of assumptions.

Once a satisfactory method is developed for determining the purchase price under the stock-purchase agreement, consider how the company can fulfill its obligations to purchase the stock. Are the company's resources adequate to carry out the terms of purchase without detrimental effects on its financial position? It is possible the company should carry sufficient insurance on the life of the owner whose stock the company is obligated to purchase. Insurance carried for this purpose should be reviewed from time to time—what is ample insurance today may become woefully inadequate in a few years.

Once a stock-purchase agreement has been executed, it becomes extremely important to consider carefully the future transfer of stock to, or acquisition of stock by, any member of the owner's family. If a member of the owner's family is an heir to the owner's estate and happens to own even a small amount of stock, the estate could be confronted with a contention that the purchase of the stock from the deceased owner's estate should be treated as a dividend. If this contention should prevail, the value of the business interest in the owner's estate might be seriously depleted.

Unincorporated Businesses

A great deal of attention has been given to incorporated business interests and to the transfer, sale, exchange or redemption of corporate stock. While the specialized problems of proprietorships and partnerships are not within the scope of this paper, many of the ideas discussed would apply to any form of business interest. It should be noted, however, that the corporation is itself an important vehicle for aiding in preserving the value of a business interest. The corporate form facilitates continuity of the enterprise, and continuity may be essential to identifying the business interest and to permitting a transfer of the business, in whole or in part, by sale, exchange, gift, or bequest. By accepting some reasonable amount of debt security upon incorporation of his business, the owner also can provide a source of cash for diversifying his investments during his life and improve the liquidity of his estate without requiring a disposition or later redemption of stock in the business.

ILLUSTRATION

A brief summary of a particular case may illustrate how combinations of several of these aids can be effectively utilized. Initially the stock ownership of X company was as follows:

Stock Owned by	*No. of Shares*	*Fair Market Value Per Cent*	*Fair Market Value Amount*
A and his family	5,500	55%	$ 550,000
Other (10 key officers and employees)	4,500	45	450,000
Total	10,000	100%	$1,000,000

"A's" wife was living and in good health. He had a daughter and one minor granddaughter. "A" concluded that upon his death the control of the company should vest in other shareholders, to whom he fairly attributed much to the success of the business. He felt shifting the control was necessary to assure continued capable management. He wished to provide a source of income for his wife, daughter, and granddaughter, but felt they should not have voting control of the business. This is the plan that was developed:

- Following an offer made to all shareholders, Mr. "A" exchanged 2,000 shares of common stock for 2,000 shares of 5 per cent cumulative preferred stock after which the capital structure was as follows:

Stock Owned by	*No. of Shares*	*Fair Market Value Per Cent*	*Fair Market Value Amount*
Common:			
A and his Family	3,500	43.75%	$ 350,000
Other	4,500	56.25	450,000
Total	8,000	100.00%	$ 800,000
Preferred:			
A	2,000	100.00%	200,000
Total			$1,000,000

- As an added hedge against possible unfavorable tax treatment in the event of a later redemption of the preferred, "A's" interest in common stock was reduced to less than eighty per cent of his interest before the exchange and his common stock was reduced to less than fifty per cent of the total voting stock.
- "A" and certain key officers entered into a ten-year voting trust agreement covering about eighty-five per cent of the voting stock. "A" was named as voting trustee.
- An agreement was entered into providing for the company to purchase the remaining stock owned by "A" at his death. The agreement contains a formula for determining the price and sets maximum terms for payment of the price.
- Lifetime gifts of some of the preferred stock are being made by "A" to persons who are not residuary legatees of "A's" estate. This will permit "A's" Executor, if necessary, to satisfy specific legacies before redeeming the common stock owned.
- Insurance on "A's" life was increased to reduce the impact of the stock-purchase obligation.

It is already apparent that these arrangements have become invaluable in preserving the value of "A's" interest in the company to which he has devoted most of his working life.

CONCLUSION

Frequently a lifetime or more has been devoted to building the value represented by an interest in a closely held business; but, unfortunately, no method exists today for guaranteeing the future value of any business enterprise. It should be apparent, though, that judicious use of the techniques available should greatly improve the odds for preserving these values.

Even with the best of planning, economic or personal circumstances may cause a diminution or loss in value of a closely held business interest. Much of the other estate planning may be for naught unless reasonable steps are taken to protect the value represented by this interest. The plans of those clients whose estates are represented largely by an interest in a closely held business should be regularly examined and reexamined. Certainly, no one would want a client or his family, to be adversely affected by poor planning or by inattention to problems surrounding the principal asset of an individual's estate.